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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 937

HAROLD B. KLINE, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 66a–171a) is reported at 401 F. 2d 833. The opinion of the district court (Pet. App. 1a–63a) is reported at 258 F. Supp. 262.

JURISDICTION

The judgment of the court of appeals was entered on August 13, 1968, and the court denied petitioner's timely petition for rehearing on October 15, 1968. The petition for a writ of certiorari was filed on January 13, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder prohibit a member of a corporation's top management from accepting an incentive stock option, purportedly based upon the fair market value of the underlying shares, without disclosing to the directors who grant the option corporate information that might be expected substantially to affect the value of the corporation's stock and that would be of importance to a reasonable, although speculative, investor.

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b–5 of the Commission, 17 CFR 240.10b–5, are set out in the petition (Pet. App. 174a–176a).

STATEMENT

This action arises out of "a major strike of zinc, copper and silver * * *" (Pet. App. 40a) by Texas Gulf Sulphur Company ("Texas Gulf") on land located near Timmins, Ontario, Canada. The exploratory drilling that preceded a release distributed at a press conference announcing this discovery on April 16, 1964, was carried out by Texas Gulf during a period of some five months (Pet. App. 1a). The court below found that, prior to sufficient dissemination of this announcement to the public, ten officers, directors and employees of Texas Gulf who possessed various degrees of information about the results of the drilling at various stages in the exploration all

engaged in securities transactions in violation of Section 10(b) and the Commission's Rule 10b–5. Petitioner is one of the ten.[1]

1. THE COMMISSION'S COMPLAINT

On April 19, 1965, the Commission filed a complaint (R. 2851–2885) in the district court alleging that, during the course of the exploratory drilling and before the information contained in the April 16 press release became available to the public, thirteen officers, directors and employees of Texas Gulf, including petitioner, had each committed one or more of the following violations of Section 10(b) and Rule 10b–5:

> 1. Purchased Texas Gulf common stock or calls on that stock on the basis of the results of the drilling without appropriate disclosure.
>
> 2. Divulged that information to friends, relatives or business associates for use in their purchases of Texas Gulf stock or calls, without appropriate disclosure, or recommended on the basis of such inside information that they purchase Texas Gulf securities.
>
> 3. Accepted stock options from Texas Gulf while this information was concealed from its directors.

It also alleged that Texas Gulf had violated Section 10(b) and Rule 10b–5 by the issuance of a false and misleading press release about the ore deposit on April 12, 1964.

The complaint requested that the defendants be

[1] Another of the ten is the petitioner in *Coates* v. *Securities and Exchange Commission*, No. 897, this Term, in which the Commission has filed a brief in opposition.

permanently enjoined from future similar violations of Section 10(b) and Rule 10b–5; that the individual defendants who had violated those provisions by purchasing Texas Gulf stock or calls be required to offer rescission to the sellers; that those who had divulged such information be required to offer restitution to stockholders who had sold Texas Gulf securities to the recipients of the information; and that stock options accepted by the defendants be rescinded (R. 2883–2885).

2. THE EVIDENCE RELEVANT TO PETITIONER

In 1963, Texas Gulf was a narrowly-based company deriving 97 per cent of its income from sulphur (R. 1842). Because of an over-supply of sulphur on the world market, during the period from 1955 to 1963 its annual sales and earnings and the market price of its common stock had declined (Pet. App. 2a–3a).

Although the sulphur market had begun to improve by late 1963, Texas Gulf was endeavoring to deal with its depressed business situation by diversifying into related fields (Pet. App. 3a–4a). One aspect of this diversification was an exploratory program for base metal sulphides[2] in Canada (R. 661; Pet. App. 5a), which, if successful, would open a new area of corporate opportunity for the company (R. 1552–1553). Up to November 1963, however, the corporation had spent six years and millions of dollars in exploring more than 15,000 square miles of eastern Canada without success (Pet. App. 5a, 8a; J.A. 1723a).[3]

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[2] Sulphides are chemical combinations of sulphur with other elements (Pet. App. 59a n.2).

[3] "J.A." refers to the joint appendix in the court of appeals, a copy of which has been lodged in this Court in connection

On one square-mile plot of land located near Timmins an aerial geophysical survey, confirmed by subsequent geophysical investigations on the ground, indicated the existence of a wide "first class" anomaly* some 1000 feet in length (Pet. App. 6a, 8a, 29a). Texas Gulf had an option to purchase the northeast quarter section of that segment (Pet. App. 6a).

In November 1963, Texas Gulf drilled one exploratory drill hole on this section (Pet. App. 8a). Although the anomaly could have been caused by worthless materials (Pet. App. 59a n.3), a visual examination of the core recovered from the hole revealed such high copper and zinc values over a length so great—approximately 600 consecutive feet of the core's 657 foot length (Pet. App. 27a–28a)—that four expert witnesses called by petitioner had never seen or heard of a comparable initial exploratory drill hole in a base metal mineral deposit (R. 723–727, 800, 1471–1476, 1584–1586, 1610–1613, 1715–1717, 1944–1946, 1967–1968). Moreover, the mineralization began 26 feet below the surface of the earth (P.X. 11, p. 1). This drill hole has been described as "one of the most impressive drill holes completed in modern times"

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with the petition for certiorari of one of the other individual defendants (*Coates* v. *Securities and Exchange Commission*, No. 897, this Term). "P.X. ——" refers to certain of the Commission's exhibits, copies of which have been lodged in this Court in connection with the present petition.

*An anomaly is a deviation from the normal in the earth's crust of such physical characteristics as electrical conductivity (R. 665).

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(Pet. App. 90a n. 13) and "just beyond your wildest imagination" (J.A. 1719a).

The "excited" company geologist who had been at the drillsite called from Timmins to his superior's home in Stamford, Connecticut, on a Sunday evening to report the initial intersection of copper mineralization (R. 898, 4818–4819). Within two days this and subsequent reports had brought three top executives of Texas Gulf, including the second senior officer of the corporation, to Timmins from New York under conditions of great personal discomfort (R. 889, 898, 956–960, 1122–1127). As a result of the information thus obtained by the top management of Texas Gulf, security measures were taken to keep the results of the drilling secret so that the corporation could acquire the remainder of the land at favorable prices (R. 1240–1241, 4801–4802). These included an order by the president of the corporation that no one outside the exploration group, not even the nonmanagement directors, should be told about the drilling results (R. 1205–1206). Drilling was suspended and was not resumed until after the transaction involved in this petition (R. 4802–4805).

At the time when the first hole was drilled, petitioner was vice president-administration and secretary of Texas Gulf (R. 4791). Sometime "near the midpoint of November, 1963" the president and executive vice president of the corporation discussed the drilling results with petitioner (Pet. App. 196a). Petitioner testified that he was told that the drill hole "had intercepted a sulphide body" containing copper and zinc, and that it was considered "a favorable de-

velopment" (Pet. App. 196a). He was also told that the drilling was done on the boundary of Texas Gulf's property, and that the corporation wished to acquire the adjoining land (Pet. App. 197a).[5]

On January 24, 1964, petitioner became general counsel of Texas Gulf in addition to his other duties (Pet. App. 191a, 197a). In these capacities he attended a meeting of the incentive stock option committee of Texas Gulf's board of directors on February 20, 1964 (Pet. App. 191a–192a). At that meeting the committee recommended the granting of options on 89,950 shares of Texas Gulf stock to officers and employees of Texas Gulf (P.X. 5, p. 2), including an option on 4300 shares to petitioner (Pet. App. 177a; P.X. 5, p. 2). Pursuant to the secrecy order of the corporation's president (see p. 6, *supra*), who had recommended the granting of the options, the news of Texas Gulf's discovery of copper and zinc in Timmins had been withheld from the members of the com-

[5] Although a telephone call from Canada was mentioned in the discussion (Pet. App. 196a), the evidence does not indicate whether this was the first telephone call from Canada, or, if so, that petitioner's discussion about the drilling results took place between that call and the completion of the first hole.

Petitioner testified that in the discussion he inquired whether the sulphide mineralization discovered at Timmins was "similar in terms of composition" to mineralization found in two other areas by Texas Gulf (Pet. App. 196a). Although the other two deposits were not sufficiently rich to be mined (R. 743), there is no evidence that any comparison was made to them in terms of richness, as distinguished from the chemical composition of the mineralization. The first hole in Timmins was far more impressive than the first holes in the other two locations (R. 725–727; see pp. 5–6, *supra*).

mittee (Pet. App. 179a, 181a–182a, 186a–188a). Although the committee expressly stated that the options were intended to be granted at the "fair market value" of the underlying stock and assumed the stock exchange prices to represent that value, petitioner, who was present while they discussed this matter, did not reveal to them anything about the drilling results (Pet. App. 181a, 197a–198a; P.X. 5, p. 3). After the meeting of the committee, petitioner also attended a meeting of the full board, at which the recommended options were granted (Pet. App. 177a, 192a).[6] None of the nonmanagement directors knew about the drilling results (Pet. 8). Petitioner thereafter handled the mechanics of issuing the options (Pet. App. 192a–195a).

Although the options thus granted have been surrendered to the corporation by two other officers of Texas Gulf, petitioner still retains his (Pet. 9; R. 4814). On July 15, 1965, after the institution of this lawsuit, Texas Gulf's board of directors resolved that the option granted to petitioner had "been beneficial" to the corporation and was expected to continue to be so (Pet. App. 178a).

3. THE DECISION OF THE DISTRICT COURT AS TO PETITIONER

The district court held that "[a] corporate officer may be guilty of fraud if he withholds material information from his company to his own advantage" (Pet. App. 48a). It also recognized that in granting

[6] He was succeeded as secretary of the corporation at the meeting (Pet. App. 192a).

incentive stock options the directors of the company necessarily rely on information furnished to them by the top management of the corporation (Pet. App. 47a), and that the latter are therefore "under a duty to inform * * * [them] of material information affecting the issuance of the stock options," including "material information bearing on the market value of * * * [the] stock on that date" (Pet. App. 48a). Thus, it agreed with the Commission that any member of top management who accepted a stock option from the corporation while withholding such information about its affairs from the directors would violate Section 10(b) and Rule 10b–5 (Pet. App. 48a–49a).

The district court held, however, that petitioner did not violate these provisions because the drilling results had not been material up to the date on which the options were granted (Pet. App. 49a). In reaching this conclusion, it held that, although "[t]here is no doubt that the [first] drill core * * * was unusually good and that it excited the interest and speculation of those who knew about it" (Pet. App. 29a), "* * * the test of materiality must necessarily be a conservative one * * *" (Pet. App. 26a). In its view, only long-term, conservative investors were to be protected against misuse of inside information (Pet. App. 25a–26a). In addition, it found that petitioner was not a member of Texas Gulf's top management, and that he "knew no details" about the drilling results (Pet. App. 47a–48a).

4. THE DECISION OF THE COURT OF APPEALS AS TO PETITIONER

The court of appeals decided the case *en banc*. The majority of seven judges agreed with the district court that under Section 10(b) and Rule 10b–5 "'* * * a member of top management * * * is required, before accepting a stock option, to disclose material inside information * * *'" to its directors (Pet. App. 103a n. 24). In determining whether the facts involved here were material, the court applied two alternative phrasings of the standard of materiality previously used in Rule 10b–5 cases: "'* * * whether a *reasonable* man would attach importance * * * [to the information] in determining his choice of action in the transaction in question,'" and whether "'* * * in reasonable and objective contemplation [the information] *might* affect the value of the corporation's stock or securities * * * '" (Pet. App. 87a) (emphasis in original).

It rejected the district court's "conservative" (Pet. App. 87a) standard. It held that all investors, including those with speculative objectives, are entitled to the protection of the Act (Pet. App. 88a). It ruled that the information about the first drill core was material, since it "might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold" (Pet. App. 89a).

With specific reference to petitioner, the court of appeals decided that he was a member of top management (Pet. App. 103a). It held that, although he "had

no detailed knowledge of the drilling progress * * *" (Pet. App. 102a), he violated his "duty before accepting his option to disclose any material information he may have possessed * * *" (Pet. App. 103a); and that this violation was not cured by the subsequent resolution by the board of directors, which the court termed a "ratification." The court ordered the rescission of petitioner's option (Pet. App. 103a and n. 24).

The two dissenting judges did not disagree that the "objective of protecting a corporation from selling securities to insiders at a price below their true worth * * *" was a proper one (Pet. App. 146a–147a). It was their view, however, that the appropriate time for disclosure with respect to stock options, at least during a period of corporate secrecy, is prior to exercise of the options rather than the time of their acceptance (Pet. App. 146a–147a).[7] In addition, they agreed with the district court that the results of the drilling were not material (Pet. App. 132a–145a).

5. THE OTHER DEFENDANTS

The district court held that two other individual defendants had violated Section 10(b) and Rule 10b–5, and that Texas Gulf and nine other individual defendants had not (Pet. App. 58a). The court of appeals affirmed as to the two individuals who had been found to be violators and as to one who had not and reversed as to all the other defendants before them

[7] The majority stated: "* * * as this suggestion was not presented to us, we do not consider it or make any determination with reference to it" (Pet. App. 103a n. 24).

(Pet. App. 118a). It remanded the case for further proceedings to determine whether Texas Gulf had violated the law and the remedies to be imposed on the violators (Pet. App. 118a). These proceedings have not yet taken place.

Although the time for filing petitions for certiorari to review the decision below has run, only one of the other individual defendants has filed a petition (*Coates* v. *Securities and Exchange Commission,* No. 897, this Term). That petition raises basically different questions from this one. Texas Gulf has announced that it intends to petition for certiorari "in due course" (presumably after further proceedings on the remand to the district court and a subsequent decision by the court of appeals). CCH Fed. Sec. Law Rep. ¶ 77,589 (Aug. 15, 1968).

ARGUMENT

All the judges of both courts below agreed that Section 10(b) and Rule 10b–5 require members of top management to disclose previously withheld material information to the directors of the corporation at some time prior to the exercise of incentive stock options granted to them. Both courts held that the appropriate time for such disclosure was prior to the acceptance of the options, although the two dissenting judges were of the view that the appropriate time during a period of corporate secrecy was prior to the exercise of the options, and the majority of the court of appeals indicated that this question was open for future cases (see n. 7, *supra*). In these circumstances,

there is no reason for review by this Court of the narrow question of timing.

The other issue raised is whether the facts which petitioner knew when his option was granted were material. The standard of materiality applied by the court of appeals in answering this question affirmatively was consistent with the standards used by other courts of appeals in cases under Section 10(b) and Rule 10b–5 and was correct. The application of that standard to the particular facts of this case was also proper and does not present an issue of sufficient general importance to warrant further review.

1. The court of appeals applied the two alternative phrasings of the standard of materiality commonly used in Rule 10b–5 cases: that the information is important to a "reasonable" investor and "in reasonable and objective contemplation" might affect the market price of the stock (see p. 10, *supra*).[8] The first phrasing of the standard is the same as the traditional common law tort standard,[9] and both have been adopted by other courts of appeals.[10] Petitioner cites

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[8] Petitioner argues that the court of appeals correctly stated that a *substantial* prospective market impact is necessary to render inside information material and then departed from this standard by dispensing with the requirement of substantiality (Pet. 17–18). We, however, read the phrase "in reasonable and objective contemplation" as designed to exclude matters which might cause insubstantial market fluctuations.

[9] See, *e.g.*, 1 Harper and James, *Torts* 565–566 (1956); Prosser, *Torts* 554–555 (2d ed. 1955); Restatement, *Torts* § 538(2)(a) (1938).

[10] *Myzel* v. *Fields*, 386 F. 2d 718, 734 and n. 7 (C.A. 8) certiorari denied, 390 U.S. 951; *Rogen* v. *Ilikon Corp.*, 361 F. 2d 260, 266 (C.A. 1); *Kohler* v. *Kohler Co.*, 319 F. 2d 634, 642 (C.A. 7); accord, *Securities and Exchange Commission* v. *R.A.*

two other decisions by courts of appeals that are claimed to be inconsistent with that of the court below (Pet. 16–17). One of them, *James Blackstone Memorial Library Ass'n* v. *Gulf, M. & O.R. Co.*, 264 F. 2d 445, 450–451 (C.A. 7), certiorari denied, 361 U.S. 815, is an earlier decision of one of the courts which has since adopted the second phrasing (see n. 10, *supra*). Moreover, the undisclosed information involved in that case could not possibly have affected the fair market value of the plaintiff's stock.[11] The other, *Sunray DX Oil Co.* v. *Helmerich & Payne, Inc.*, 398 F. 2d 447 (C.A. 10), does not articulate any standard of materiality, and there is no indication that the drilling results in that case were as "remarkable" (R. 1717; see pp. 5–6 *supra*) as those here.[12]

Holman & Co., 366 F. 2d 456, 458 (C.A. 2), rehearing denied *per curiam*, 377 F. 2d 665 (C.A. 2), certiorari denied, 389 U.S. 991; *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (C.A. 2), certiorari denied, 382 U.S. 811. The court of appeals has used the first phrasing subsequent to the decision below, with one of the two dissenting judges here joining in the opinion. *Securities and Exchange Commission* v. *Great American Industries, Inc.*, CCH Fed. Sec. Law Rep. ¶ 92,325, at 97,540 (*en banc*).

[11] The undisclosed information concerned the possibility that certain property in the corporation's name might be sold to the government at an advantageous price. All the property of the corporation had already been leased to another party in perpetuity, however, and a sale at a large profit would not have affected the guaranteed dividend, which is all that plaintiffs were entitled to receive. 264 F. 2d at 447–448, 450.

[12] Neither of the two well holes in question was on the land involved there; one was over a mile away from its boundary. See unreported findings of fact and conclusions of law in the district court, p. 7, No. 68 C 92 (N.D. Okla).

Petitioner argues that the refusal of the court of appeals to limit the "reasonable" investors encompassed within the first phrasing of the materiality standard to long-term, conservative investors is inconsistent with certain rules of the Commission defining materiality in the context of registration statements and other similar filings (Pet. 15–16). There is no inconsistency. Certain of the filings with the Commission relate to securities which would be of interest only to speculators, while others describe securities appealing to more conservative investors. The Commission's standard of materiality for registration statements applies to both.[13] Moreover, as this Court has recently stated,

> Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase "unless the context otherwise requires."

Securities and Exchange Commission v. *National Securities Inc.*, No. 41, this Term, decided January 27, 1969, slip op., p. 12. The rules cited by petitioner supplement specific detailed requirements for the disclosure of specific information. They have been drafted in light of the Commission's experience, in obtaining

[13] The Commission has a special registration form for securities of a speculative nature, which must be so labeled. Form S–2, General Instruction D(b), reprinted in 1 CCH Fed. Sec. Law Rep. ¶ 7142, at 6241–6242; see, also, Form S–3, General Instruction E(b), reprinted in 1 CCH Fed. Sec. Law Rep. ¶ 7152, at 6262. Registrants are not allowed to leave these forms blank merely because the information required would be important only to speculators.

information in that context, whether of interest merely to long-term, conservative investors or to all reasonable buyers and sellers of securities. Congress, in designing the Act "* * * to prevent inequitable and unfair practices on * * * exchanges and markets * * *," 48 Stat. 881, did not intend to exclude speculative investors from its protections. Indeed, Congress expressly recognized that speculators need relevant information in order to make intelligent investment decisions, as do more conservative investors.[14]

2. Although concededly petitioner did not have all the information available to the other defendants about the drilling results (see pp. 5–7, 9–11, *supra*), the court of appeals properly held that he should not have accepted stock options while this information was concealed from the directors.[15] Like the other recipients

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[14] Although one of the purposes of the Act was to curb *excessive* speculation, the House committee that reported out the bill that eventually became the Act stated that "[t]here is plenty of room for *legitimate* speculation in the balancing of investment demand and supply * * *"; it went on to recognize that "[n]o investor, no *speculator*, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." H. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 11 (emphasis added).

[15] In reviewing the decision of the district court, the court of appeals was not bound by the lower court's conclusions as to materiality. The evidentiary facts were basically undisputed, and the court of appeals accepted the findings of the district court in this regard. In both its main brief (pp. 4–5, 24, 27) and reply brief (pp. 1–2) in the court of appeals, the Commission relied solely upon the district court's evidentiary findings, the undisputed facts and the testimony of the defendants and their own experts with regard to the materiality of this drilling; it did not rely upon any testimony of its own experts. Copies of these briefs have been lodged in this Court.

of the stock options, petitioner was receiving a bonus from directors from whom important facts were concealed. His awareness of the concealment from the directors is a matter peculiarly within his own knowledge and, in the circumstances of this case, was properly presumed in the absence of his coming forward with proof that he was not aware of it. As secretary of the corporation, it was his duty to attend the board meetings and take notes of the proceedings (Pet. App. 192a), and he therefore must have known that the drilling had not been discussed there. Petitioner was called as a witness by the Commission and was cross-examined by his counsel. If he had been unaware of the concealment, he had every opportunity to say so. Any deficiency in the record in this regard (Pet. 9n., 22–23) is, therefore, chargeable to petitioner himself.[16]

This Court has repeatedly held that Rule 52(a) of the Federal Rules of Civil Procedure does not shield findings of fact based upon the application of erroneous legal standards to undisputed evidentiary facts. *E.g.*, *United States* v. *General Motors Corp.*, 384 U.S. 127, 142 n.16; *United States* v. *Parke, Davis & Co.*, 362 U.S. 29, 44. In any event, the ultimate question of materiality is one of law subject to review by the court of appeals. *E.g.*, *United States* v. *Bernard*, 384 F. 2d 915 (C.A. 2) (*per curiam*); *United States* v. *Ivey*, 322 F. 2d 523, 529 (C.A. 4), certiorari denied, 375 U.S. 953; *United States* v. *Parker*, 244 F. 2d 943, 950 (C.A. 7), certiorari denied, 355 U.S. 836.

[16] Petitioner's argument that he could not violate Section 10 (b) and Rule 10b–5 unless he actually knew that the drilling results were unavailable to the directors (Pet. 22) is also inconsistent with his own definition of *scienter* as including reason to know that they were uninformed (Pet. 23).

We recognize that the rather limited knowledge of the drilling results attributable to petitioner on the basis of this record makes it a close question whether petitioner's knowledge was material under the standard adopted by the court below. We believe, however, that the court was warranted in concluding that the test of materiality was met by the fact that the corporation's president and executive vice president considered the "favorable development" of the drilling results significant enough to discuss the news with petitioner and to tell him that they wanted to acquire the adjoining land (see pp. 6–7, *supra*). In any event, the question was fully considered by the court of appeals *en banc* (see Pet. App. 102a–103a, 146a), and there is no reason why this Court should review the correctness of that court's application of proper legal standards to these peculiar facts.[17]

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[17] Unlike some of the recipients of the stock options, petitioner was a member of the corporation's top management, was present at the meetings of the board of directors and its stock option committee, and was informed that the initial stage of a generally-concealed corporate development of great potential was favorable (see Statement, *supra*, pp. 6–8, 10). The court of appeals undoubtedly recognized that since the purpose of employee stock options is to encourage and reward effective performance on behalf of the corporation, the law—whether substantive or remedial—should not place a premium on lack of diligence by a member of top management in ascertaining whether corporate developments of which he has been informed are sufficiently favorable to require their disclosure to the directors because of their material bearing on the award of stock options.

3. As the court of appeals noted (see n. 7, *supra*), petitioner did not argue below that the appropriate time for disclosure to the directors was prior to exercise of the option rather than prior to its acceptance. In a somewhat indirect manner he does make that argument in this Court (Pet. 13, 25). While we do not believe that issue should now be decided by this Court since the court of appeals has left it open for future cases (see p. 12, *supra*), it is clear in any event that the time of acceptance of the option is the relevant time, for that is when the directors need the information in order to determine whether and on what terms to issue the options. This does not mean that the interests of the corporation need be compromised by premature disclosure of corporate secrets. If it is appropriate not to reveal those secrets to the directors, it should be sufficient for the management merely to recommend that the granting of stock options be postponed. As pointed out in the concurring opinion of Judge Friendly, nonmanagement directors would not ordinarily challenge such a recommendation from top management (Pet. App. 120a).[18]

Moreover, the stock option plan approved by the Texas Gulf shareholders required that the options be

[18] Judge Friendly also questioned the justification for management to erect a wall of secrecy between the directors, who are charged with the responsibility for managing the corporation, and important developments in its affairs (Pet. App. 120a).

exercisable at the "fair market value" of the underlying stock on the date they were granted, not some other date, and that their granting and exercise "be subject to all applicable laws, rules and regulations * * *" (P.X. 7). It is at least questionable whether this particular plan authorized the directors to ratify options the original issuance of which was defective because it involved a violation of the federal securities laws, and the exercise price of which was far below the fair market value on the date that this defect was attempted to be cured.[19]

If the appropriate time for disclosure, even when corporate secrecy is thought to be necessary, is the granting of the options, then subsequent action by the board of directors cannot cure a violation that has already occurred. Since this is an enforcement proceeding brought by the Commission, ratification can have no effect here, whatever its significance as between petitioner and Texas Gulf.

4. Relying on the Fifth Amendment, petitioner also complains that Rule 10b–5 is not sufficiently definite to have given him notice that his conduct was proscribed (Pet. 24).

In this area "[t]he test is whether the language conveys sufficiently definite warning as to the proscribed conduct when measured by common understanding and practices." *Jordan* v. *DeGeorge,* 341

[19] Although both courts below describe the resolution of July 15, 1965 as a "ratification", it is doubtful whether it rose to that level. (see pp. 8, 11, *supra*)

U.S. 223, 231–232; accord, *United States* v. *National Dairy Products Corp.*, 372 U.S. 29, 32; *McGowan* v. *Maryland*, 366 U.S. 420, 428; *Sproles* v. *Binford*, 286 U.S. 374, 393. See, also, *Securities and Exchange Commission* v. *Capital Gains Bureau*, 375 U.S. 180, 193, n. 41, 199.

There are, of course, some areas of the law in which it is not possible to anticipate all harmful conduct by specific rules. Prohibitions of fraud and deception fall within this category. Rule 10b–5 is, therefore, necessarily stated in rather broad terms, which absorb their meaning from the particular business context in which the deceptive practices occur. Cf. *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194, 202–203.[20]

5. Petitioner finally contends that the court of appeals' order of rescission, disregarding the order of the district court that there be a subsequent hearing on remedy in that court, deprived him of his right to be heard (Pet. 26). The court of appeals recognized that questions of remedy were generally to be deferred (Pet. App. 69a n.1), but apparently regarded the surrender of petitioner's option as the only appropriate remedy once it was determined that the option had been accepted in violation of the statute. Petitioner had the opportunity to urge in the petition for rehearing to that court that "rescission goes beyond statutory authority and the proper exercise of federal equity power" (Pet. 26), and, in fact, he did

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[20]See, also, remarks of Judge Friendly in *Conference on Codification of the Federal Securities Laws*, 22 Bus. Lawyer 793, 900, 901 (1967).

so briefly.[21] As to that issue, this Court has previously upheld the power of the government to seek, and the courts to grant, restitution as an ancillary remedy in the exercise of the courts' general equity powers to afford complete relief. *Mitchell* v. *DeMario Jewelry,* 361 U.S. 288; *Porter* v. *Warner Holding Co.,* 328 U.S. 395; cf. *J. I. Case Co.* v. *Borak,* 377 U.S. 426, 433–435. This remedy, which is necessary to deter future violations by removing any monetary incentive to risk injunctive relief, may be afforded to the government even though injunctive relief is neither sought nor granted. See *United States* v. *Moore,* 340 U.S. 616.[22]

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[21] See pages 26–27 of the petition for rehearing which has been lodged in this Court.

[22] Subsection (e) of Section 21 of the Act, 15 U.S.C. 78u, refers only to injunctive relief. Subsection (f), like the statutory provision involved in the *Moore* case, *supra*, gives the courts jurisdiction to grant "writs of mandamus commanding any person to comply with the provisions of this title * * *." Thus, *United States* v. *Parkinson*, 240 F. 2d 918 (C.A. 9), which involved a statute that authorized only injunctive relief, does not conflict with the decision below.

CONCLUSION

Despite the significance of the case out of which this petition for a writ of certiorari arises, the petition itself does not present any questions warranting review by the Court and should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

PHILIP A. LOOMIS, Jr.,
General Counsel,
DAVID FERBER,
Solicitor,
FRANK E. KENNAMER, Jr.,
Assistant General Counsel,
DONALD M. FEUERSTEIN,
Assistant General Counsel,
HARVEY A. ROWEN,
Attorney,
Securities and Exchange Commission.

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